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Pessimistic expectation may for a time acquire a causal role. But it is necessary to warn against overrating its importance… No great crisis has ever come about that was not fully explainable by the objective facts of the situation. Expectation not so conditioned never has produced more than short-lived spurts or breaks. And this is true not only for general business situations but for any particular market.

Joseph A. Schumpeter, *Business Cycles*, 1929

2000-01 VERSUS 1929-30

Headed by Wall Street, global stock markets are in a freefall, devastating the paper wealth that the speculative bubble had created. Over the past year nearly $10 trillion has been wiped off global share values, of which about 40% has been lost in the United States. As a result of sliding share prices, the net worth of American households fell in 2000 for the first time since records began 55 years ago. The Fed's latest, desperate interest rate cuts have been washed away as if they never happened. Wall Street bulls are screaming in despair for more and more quick rate cuts. This crisis is definitely "made in the USA." A lot is written about Japan's "sick economy." Most people have yet to realize that, from a perspective of economic and financial structures, the U.S. economy, with its ludicrous debt mountains, its negative personal savings and its monstrous current-account deficit, is basically far sicker than Japan's economy.

While stock markets are in a tailspin, the outbreak of the second Turkish financial crisis in three months has triggered a global "emerging market" crisis that is now hitting Russia, Asia and Latin America. Currencies and financial markets of the periphery countries are getting hammered, highly reminiscent of the Asia-Russia crisis in 1997/98, except for one very important difference. The present economic crisis is happening right in the center of the world financial system.

A crisis "made in the USA" has, of course, a famous precedent: the Great Depression of 1929-33. Most people, for sure, are of the opinion that any comparison between then and today is grossly misplaced. But we think this comparison is highly appropriate. We hasten to add, however, that we don't expect economic weakness anywhere near as severe as in the 1930s. An unusual confluence of extremely depressive factors made for the extraordinary severity and length of that crisis.

The depression in the United States followed seven boom years, during which GDP grew on average by 5.5% a year and unemployment came down to a low average of 3.5%. With zero price inflation during the whole boom, Wall Street celebrated it as a New Era, justifying the skyrocketing stock prices. All this ended abruptly in 1930 with a vertical collapse of GDP by 8.9%, after 4% growth in 1929. Over the next four years to 1933, output fell by 32%. But taking capacity growth into account, it represented a shortfall below trend of 46%.

The United States experienced by far the worst economic decline among the industrial countries. While Europe as a whole had an absolute fall in output by only 5% and of 12% below trend, in France and Germany it was about 15%. It has been calculated that 80% of the Great Depression, in so far as it affected industrial countries, occurred in the United States. These numbers leave no doubt: The Great Depression was "made in the USA."

How could this disaster happen in the wake of such a healthy boom with record-high productivity growth

and absolute price stability? Putting it briefly: It was in reality a very sick boom. Zero inflation and high productivity growth camouflaged a "bubble economy" that generated unprecedented economic and financial imbalances that came home to roost when the bubble burst.

POST-BUBBLE RECESSION

As we have many times warned, the U.S. economy is in the early stage of a recession that will prove unusually severe and long. This has the very same reason as the Great Depression of the 1930s: outrageous credit and speculative excess, leaving behind glaring economic and financial imbalances. The main difference between the two periods is that those over which Mr. Greenspan has presided are far worse than those in the 1920s. Simple logic and Austrian theory suggest that the severity of recessions is broadly proportionate to the magnitude off the excesses and maladjustment that developed during the boom.

The second reason for our extremely dismal view of the U.S. economy's prospects is our radical disagreement with the blind confidence of most American economists that monetary easing never fails to work its stimulatory "magic" on the economy.

Next, we come back to our earlier distinction between two different kinds of recessions (as described in the February letter): the short and sharp, self-correcting inventory correction versus the protracted and painful "post-bubble" recession involving major corrections in consumption and fixed investment. Which of the two is the United States presently in?

With utter amazement we note that Mr. Greenspan and Wall Street's pundit consensus speak of nothing but a quick and brief inventory recession. It is, of course, the one greatly comforting explanation, only it flatly belies the facts. This most rapid slowdown of the U.S. economy since World War II is concentrated in sharply lower fixed investment and consumer spending, and therefore clearly belongs to the dangerous "post-bubble" type of economic downturn. The contribution of consumer spending to real GDP growth has slumped from 5.03 percentage points in the first quarter of 2000 to 1.88 percentage points in the fourth quarter, and for fixed business investment the contribution is down from 2.68 percentage points to -.30 percentage points. Though these are the most important and most critical features of the economic downshift, they are entirely ignored.

DENIAL

With equal readiness it is accepted wisdom that overly tight monetary policy and higher energy prices are the downturn's chief causes, essentially implying that a few cuts in interest rates will quickly restore confidence and economic growth. They even have a comforting explanation for the unusual violence of the slump: the new information technology enables firms to respond far more quickly than in the past to shrinking orders and rising inventories. Happily, this faster downward adjustment also inherently makes for a faster recovery.

As always, Mr. Greenspan acts as a cheerleader, recently hailing the quicker adjustment to emerging imbalances in a recent congressional testimony as beneficial because "*it means that those imbalances are not allowed to build until they require very large corrections.*" Yet he admits and warns that it's a mix blessing: "*As a consequence, firms appear to be acting in far closer alignment with one another than in decades past… The result is not only faster but also 'potentially'more synchronized adjustment, compressing changes into a shorter time frame*." But in the same vein, he stresses that the speedier correction of inventories and payroll will also implicitly precipitate the V-shaped recovery, once the excess inventories are cleared away. To quote cheerleader Greenspan again: "*The same forces that have been boosting growth in structural productivity seem also to have accelerated the process of cyclical adjustment.*"

This comforting explanation of what is currently happening in the U.S. economy has one little snag:

Inventories and payroll are the only aggregates that have continued to rise. Everything else is plunging.

Later in the speech, Mr. Greenspan comes to the reason for his rapid-fire interest rate cuts, offering it plainly as an excuse: *"Because the advanced supply-chain management and flexible manufacturing technologies may have quickened the pace of adjustment in production and incomes and correspondingly increased the stress on confidence, the Federal Reserve has seen the need to respond more aggressively than had been our wont in earlier decades."* So, it wasn't panic that had gripped him, but his insight into the vicissitudes of the new information technology.

What has the chairman of the world's leading central bank to say about the decisive cause of the U.S. economy's sharp downturn? He can't admit, of course, that it was his own monetary policy, since he will hardly blame himself for overly tight money, so he offers a different explanation: *"It is difficult for economic policy to deal with the abruptness of a* ***break in confidence****… This unpredictable rending of confidence is one reason that recessions are so difficult to forecast. They may not be just changes in degree from a period of economic expansion, but a different process engendered by fear.* ***Our economic models have never been particularly successful in capturing a process driven in large part by nonrational behavior."***

Observing the torrential flow of bad news out of Corporate America and, in particular, out of the technology world, we have some difficulty identifying the dismal behavior of the stock market and business investment as just "irrational." On the contrary, it seems to us that the decline in confidence, though quite sharp, is badly lagging the economy's dramatic deterioration. Considering further the strong dollar and the consensus expectation of a V-shaped recovery in the second half of this year, which is pretty near, we can only conclude that "new paradigm" optimism about the U.S. economy remains very much intact, just as over-confidence in Mr. Greenspan's ability to fine-tune economic growth does. Nor do we see signs of outright fear in the marketplace. There is definitely no pessimism. But this, of course, begs the question, what is driving the tailspin of stock prices? Our preliminary answer: the miserable state of the economy and collapsing profits.

INCOME DEARTH…

The other day, the *Financial Times* carried at the top of its first page a big headline trumpeting "Equity gloom sends dollar to 15-year high." Underlying the dollar's rise, according to the report, is strong confidence that interest-rate cuts by the Federal Reserve would eventually revive economic growth. In contrast, the European Central Bank, leaving rates unchanged, is seen as risking a decline in European growth. Reading this, we wonder why the high-riding confidence about the U.S. economy which bolsters the dollar is not at all helping the U.S. stock market. We presume this is chiefly because corporate stocks, in contrast to the currency, are more directly exposed to the daily barrage of profit warnings.

Over time, for sure, the U.S. currency will follow the diving stock market, as the steady stream of bad economic news will finally shatter the false new paradigm hype, sending stock prices to ever new lows. Considering that stock valuations, even with the steep plunge in stock prices, are in general still at prodigal levels, there is a further large scope on the downside. The S&P 500 is trading at 25 times earnings and the Nasdaq composite at more than 6 times that multiple. To quote Grant's: *"In times past, these were valuations of euphoria, not disillusionment."* Very few people see what we perceive: the demolition of the U.S. bubble economy, implying a deep and long recession and the total destruction of the paper wealth that accrued from it. While fear over Japan continues, it should instead be focused on the grotesquely imbalanced U.S. economy and its fragile financial system.

While speaking to Congress, Mr. Greenspan emphasized consumer confidence as the key to how far the economy will slide. For sure, the indexes of consumer confidence have taken steep declines, and consumer

spending has substantially weakened, but it's far from a collapse. Many draw comfort from the belief that the confidence numbers are worse than the public's actual behavior.

Let us therefore take a closer look at consumer spending and its financial underpinning. From September 2000 through January 2001, real disposable income of private households was just flat. Higher spending had to be met by running down saving that went negative by about $70 billion. After all, consumer spending contributed 2.8 percentage points to real GDP growth of 1.1%. Still, this was significantly down from 4.5% in the third quarter of 2000 and 5.3% each in 1999 and 2000.

Nevertheless, it is widely hailed as very positive for the economy that the consumer has been so kind as to keep his retrenchment in spending within limits. That's only partly true. The figures show drastic cuts both in durable and nondurable goods. What has sustained the total has been spending on services, up 5%, of which the greatest part, though, has to be regarded as "essentials," for example housing, household operations, medical care, transportation, etc. So far, there has been far more consumer retrenchment than the aggregate figures seem to suggest.

That leaves us with the question of the consumer's future spending power. Looking at the following table, he appears close to bankruptcy. Real income growth has turned abysmal. Consider that consumer price inflation ran at 4.4% annual rate from December through February. Just to maintain his spending, the consumer has to borrow at the expense of saving.

GROWTH IN DISPOSABLE CONSUMER INCOME AND SPENDING (BOTH IN CHAINED DOLLARS), IN %

	1999	2000						2001
			Aug.	Sept.	Oct.	Nov.	Dec.	Jan.
Income	3.2	2.8	0.3	0.8	-0.5	-0.1	0.2	0.0
Spending	5.3	5.3	0.5	0.5	0.1	0.1	0.2	0.2
Personal Saving*	2.2	-0.1	-0.4	0.0	-0.7	-0.9	-0.8	-1.0

* as percentage of personal disposable income in current dollars

Source: Department of Commerce, Survey of Current Business

We are tempted to say that while the consumer has retrenched his spending, the rapidly slowing economy has retrenched his spending power out of real income growth even faster. In January, it was zero in real terms, implying that the whole of the rise in spending was credit-financed. His indebtedness grew by $538.2 billion in 1999 and by $572.5 billion in 2000. And ominously, this stagnation in real disposable income is happening even before the recession has officially arrived. This has no precedent in the whole postwar period. Besides, it hardly suggests true pessimism on the consumer's part.

<u>…BUT CREDIT GLUT</u>

Just as misplaced is the widespread proclivity to blame the dramatic reversal in the U.S. economy and the stock market on "overly tight monetary policy" imposed by the Greenspan Federal Reserve. Truly tight money would have to show in significant credit restraint. What we actually see is the extreme opposite: outrageous credit glut. Credit expansion in the third quarter briefly slowed down. But in the fourth quarter, it was running absolutely wild again. Total nonfederal credit surged by $2,249 billion, of which the nonfinancial sector accounted for $1,170.2 billion and the financial sector for $1,079.0 billion (all figures are at annual rate). To tell the truth, there is an immense "wall of hot money" stoking the financial markets, but very little of it makes its way into GDP, which grew a miserable $73.4 billion, also at annual rate.

This ludicrous discrepancy between runaway credit expansion and miserable GDP growth raises the

question, how and why can the economy and the stock market fare so abysmally despite uninterrupted runaway credit creation?

As we have repeatedly stressed, the complete disregard of the stunning financial excesses that have taken place in the U.S. economy in the last few years is one of the most perplexing facts. We have to conclude that this absolute lack of interest in the boom's monetary underpinning reflects an equal lack of understanding of the role of money and credit and the risks that such excesses breed.

This brings us to the all-important question: What is the actual cause of the present, unconventional downturn in the United States? The above figures show a further prodigious flow of credit until late 2000 and disclose the talk of monetary tightness as absolutely ridiculous. Actually, it is the very same question asked about the cause of the Great Depression. Was it the Fed's failure to provide sufficient liquidity after the stock market crash of 1929? Or was the depression the unavoidable consequence of the reckless boom-time money and credit excesses in the years before the stock market crash?

WHEN WAS THE BLUNDER MADE?

Milton Friedman's answer to those questions has definitely played a momentous role. Until he proposed his views, it was the consensus view among economists that the financial and economic crisis had its roots in the financial excesses and economic maladjustments that had developed during the prior boom. This view inherently implied that the decisive mistakes in monetary policy were made during the boom, that is, before the stock market crash.

With their book *A Monetary History of the United States* (1963), Milton Friedman and Anna Jacobson Schwarz virtually rewrote history by putting the blame for the Depression exclusively on the ineptness of the Federal Reserve in post-boom 1929. The bottom line of their review was that *"the U.S. economy's collapse from 1929 to 1933 was by no means an inevitable consequence of what had gone before during the boom. It was a result of the policies followed during those years… Alternative policies that could have halted the monetary debacle were available throughout those years. Though the Reserve System proclaimed that it was following an easy-money policy, in fact, it followed an exceedingly tight policy.*"

Since the publication of Friedman's and Schwartz's book, almost all American economists and investors now commonly subscribe to two doctrines concerning monetary policy: first, it is irrelevant what happens during the boom; and second, central banks have the power to prevent a recession under any circumstances by pouring ample liquidity into the economy and the financial system.

The current discussion perfectly accords with these two postulates. It is readily forgotten that it took several years of extremely low interest rates and loose money after the 1990-91 recession to restart satisfactory economic growth, with Mr. Greenspan, by the way, already at the Fed's helm. Nor does the sight of Japan's horrible post-bubble experience disturb anybody. The only cause that America's pundit consensus can think of is ineptness of the Bank of Japan in monetary policy. Mr. Greenspan, for sure, is not disposed to this blunder.

Actually, we wonder how many living economists have actually read the Friedman/Schwartz book. All most current economists seem to know is a vague notion of the apodictic verdict of the two authors about one single, decisive cause of the Depression: Fed ineptness to prevent the sharp contraction of the money supply. *"The monetary authorities could have prevented the decline in the stock of money – indeed, could have produced almost any desired increase in the money stock."* (Note the "almost.")

On the question of how the authorities could have boosted the growth of the money stock, their answer is,*"by extensive open market purchases"* as a means to increase bank reserves.

That is, the central bank increases bank reserves by buying government bonds. Assuming that the higher reserves intrinsically lead to multiple credit and money creation, such open market purchases for many American economists are tantamount to a central bank's "printing money."

Friedman/Schwartz: "*It has been contended with respect to later years that increases in high-powered money, through expansion of Federal Reserve credit or other means, would simply have added to bank reserves and would not have been used to increase the money stock…We shall argue later the contention is invalid even for the later period. It is clearly not relevant to the period from August 1929 to October 1930. During that period, additional reserves would certainly have been put to use promptly. Hence the decline in the stock of money is not only arithmetically attributable to the decline in Federal Reserve credit outstanding: it is economically a direct result of that decline*."

Underlying this judgment were three pivotal assumptions: first, that changes in the money stock determine the changes in real output; second, that the contraction in the money stock during those years crucially resulted from insufficient bank reserves; and third, that a looser reserve policy by the Fed would have prevented the depression. As we shall show, the available data make these assumptions utterly implausible.

THE BANKING CRISIS THAT WAS CATACLYSMIC

What exactly happened in 1930, the year after the stock market crash? Let's take a look at three features: psychology, economy and events in the financial sphere.

While the stock market crash came like a bolt out of the blue, in general it was rather taken in stride. Between Oct. 24 and Nov. 13, the Dow Jones index plunged 48%, which many people regarded as a healthy shakeout of speculative excesses. Looking back on eight years of very strong growth with zero inflation, few expected more than a normal economic setback, if one at all. As the Fed had slashed its discount rate twice in November, stock prices rallied strongly, security issues were large and signs of improvement showed in many spots. General improvement was confidentially predicted for the first half of 1930. After four further cuts of the Fed's discount rate in half-point steps, by June 30, 1930 it was down to 2.5%, from 6% in August 1929.

Quoting Schumpeter: "*Until about the end of June business moved along on a but slowly falling level. But the second half of the year presented a wholly different picture. Rates of contraction quickened all round. All of a sudden, the economy was swamped by the torrent of a process of readjustment corresponding in magnitude to the extent of the industrial revolution of the preceding 30 years. People, for the most part, stood their ground firmly. But that ground itself was about to give way… There was, however, no panic or even alarm until, late in the year, distress signals showed in the banking sphere.*"

It is undisputed that the first banking crisis in October-November 1930 was critical in shattering the still prevailing confidence and in converting what had so far looked like a normal recession into a deep, protracted depression. We come to the decisive conundrum as to what caused the Great Depression – was it the unsustainable boom excesses or overly tight money after the stock market crash?

According to Friedman/Schwartz, "*The deterioration in the quality of loans and investments in the later twenties or simply the acquisition of low-quality loans and investments in that period… was a minor factor in the subsequent bank failures.*" What caused the fatal contraction in the money supply was the fact that the "*banking system as a whole was in a position to meet the demand of depositors for currency only by a multiple contraction of deposits, hence of assets. Under such circumstances, any runs on banks… became to some extent self-justifying, whatever the quality of assets held by the banks. Banks had to dump their assets on the market, which inevitably forced a decline in the market value of those assets they held. The impairment in the market value of assets held by the banks… was the most important source of impairment of capital leading to bank*

suspensions, rather than the default of specific loans or of specific bond issues.”

The Friedman/Schwartz hypothesis, the compelling history of the Great Depression for American economists, asserts that overly tight money converted a normal, short recession into the unparalleled, sustained Depression of the 1930s through a sequence of banking crises. The first of these panics occurred in October-November 1930s. Other banking crises followed, but for various reasons the first crisis is supposed to be of central importance.

IT WAS THE MARKETS THAT SCUTTLED THE BANKS

In the view of Friedman/Schwartz, bad loans and investments were no different in quantity and quality from earlier periods. What endangered the whole banking system, by their verdict, were associated contractive effects on bank reserves. As frightened depositors demanded currency, the banks lost an equal amount of reserves. In order to meet their reserve requirements, the banks had to curtail their deposits, and hence their assets, by a multiple amount. Scrambling for liquidity, the banks dumped some of their bond holdings on the market. Falls in bond prices resulting from these sales correspondingly decreased the market value of the entire bond portfolios and, essentially, these losses ravaged their capital base. To Friedman/Schwartz, this was the beginning of the Great Contraction, which could have been avoided, according to their conclusion, if only the Fed would have eased the reserve position of the banks.

This impressive and familiar story has but one little snag. It completely belies the facts. Currency held by the public in December 1930, at $3,809 billion, was minimally higher than the $3,800 billion it held in December 1929. Bank reserves rose during the year from $2,304 billion to $2,433 billion, while bank deposits fell slightly from $41,543 billion to $40,245 billion. These minimal changes in the monetary setting hardly suggest that they drove the U.S. economy into the Great Depression. Instead, they imply that the Depression must essentially have been caused by other than monetary causes.

Given $2,500 billion of bank reserves at the time, the Friedman/Schwartz hypothesis effectively conjectures that a reserve injection of perhaps $500 billion would have been enough to prevent the banking crisis by stopping the banks’ bond sales – thus preventing the Great Depression. But the situation in the American banking system was in reality anything but normal. The years 1922-29 had seen a rapid expansion of bank credit, involving correspondingly strong money growth. But this money and credit creation had taken place in the most unusual way — through the securities markets, financed by bank money.

In 1927, bonds and notes accounted for 63% and stock issues for 32% of total corporate new financing. But as stock prices soared and stock yields plunged, corporations shifted their new financing activities heavily to stock issues, accounting for 74% of corporate external financing in 1929, after 55% in 1928. The share of bonds and notes, by comparison, fell to 41% in 1928 and further to 23% in 1929. The important thing to see is that financing took place almost completely through the markets.

How, then, did the banks make their living if the markets did all the financing? Confronted with slight credit demand, they had to look for other profitable outlets. They found three of them: investment on their own account in lower-grade, high-yielding corporate bonds; loans to buyers of bonds and stocks; and mortgage credit. In 1929, bond investments accounted for 30% of total bank assets and loans on securities for another 20%. All told, bank credit entered the economy via the securities markets.

Massively tapping the bond and stock market, the corporations used the proceeds to retire their indebtedness to banks – with two ambiguous effects. One was slower growth of the money stock, and the other one was to boost the prices of the securities, or conversely, to lower equity yields and the long-term market rate of interest. Together, it was a mechanism that artificially lowered the cost of credit and capital. That was one snag. The

other one was an inordinate exposure of the banking system to the vagaries of the financial markets.

Quoting Schumpeter: *"The concerns eventually entered the great depression with a financial outfit which was nothing short of luxurious."*

The day of reckoning for the banking system came late in 1930 as the market value of their outsized bond portfolios went sharply downhill, seriously impairing the capital structure of many banks. In the Friedman/Schwartz view, the sharp depreciation of the bonds owed chiefly to the reserve tightness, reflecting a flight of the public into cash that forced the banks to dump bonds on the market. But this ought to have shown in higher currency circulation, shrinking reserves and deposits. Except there is no trace of these effects.

There is a more convincing, even compelling, explanation for the plunging bond values. It was the sliding economy. GDP in the course of 1930 had plunged nearly 9%. Yet in flat denial of the abysmal performance of the economy and the stock market, there had remained complacent confidence that "recovery was around the corner." Apparently the first banking crisis in October-November 1930 was the cataclysmic event that suddenly and finally shattered the unclouded confidence. Therefore Schumpeter's famous remark: *"People, for the most part, stood their ground firmly. But that ground itself was about to give way."* For Friedman/Schwartz, this episode set the pattern of monetary deadlock and inaction on the part of the Federal Reserve for years to come.

But why the falling bond values that triggered this banking crisis? They were strikingly confined to lower-grade bonds and their nationwide downgrading with the effect of a sharply rising risk premium, due to the dramatically worsening economy. Only their prices fell, while the prices of higher-grade bonds stayed roughly constant. The most serious feature was collapsing corporate profits. Actually, the decline in bond values had started in early 1929. But it was in late 1930 that it sharply accelerated, apparently in response to the belated collapse of confidence. It was not the banking crisis that caused the losses in the markets; rather the losses in the markets produced the banking crisis.

Most intriguing, rather, was something else, and that is the fact that the existing money supply barely budged until March 1931 while the economy collapsed. Statistically, this worked out as sliding money velocity, but economically, it essentially reflected a soaring demand for money. Simple logic suggests that businesses and consumers, faced with collapsing bond and stock prices, now vainly tried to rebuild liquidity through cutting their spending.

Yet there effectively was an immediate massive credit squeeze. But it showed neither in the banks' balance sheets nor in the money supply because it was happening in the financial markets, outside the banking system. New issues of stocks and bonds collapsed. The markets had called the tune in the financial system during the boom, and they did so in reverse.

CONSUMER CREDIT MADE THE DIFFERENCE

Still, it needs explanation why both consumer spending and fixed investment abruptly broke down. The following table shows the contributions of the various demand components, first, to the expansion during the boom years, and later to the GDP contraction during the depression. Just like the 1990s' boom, the growth pattern of the 1920s' emerges as grossly imbalanced. All through the 1920s, the U.S. economy had a high rate of capital formation, but it effectively peaked in 1926, from then on contributing next to nothing to the economy's expansion. The overriding source of growth since 1927 was consumer spending.

After this brief review of the U.S. economy's boom-bust in the 1920-30s, let us look now at the current boom-bust. The first thing to see is that the propellants and the pattern of economic growth in the two periods are closely similar. They share five unconventional features: (1) craze about a new technology; (2) free rein by

the Fed to uncontrolled credit growth; (3) inordinate capital gains in a booming stock market that encouraged and facilitated a rampant consumer borrowing and spending binge; (4) an effective, extraordinary surge in consumer spending; and (5) a sharply higher participation of the public in the booming stock market.

CONTRIBUTIONS TO U.S. GNP GROWTH IN PERCENTAGE POINTS, 1927- 1932

	1926	1927	1928	1929	1930	1931	1932
Change in GNP in %	6.5	1.0	1.1	6.1	-8.9	-8.1	-12.7
Consumption	5.7	1.6	1.6	4.0	-4.2	-2.6	-6.0
Fixed investment	1.2	-0.7	0.3	-0.3	-4.0	-4.6	-4.6
Government	0.0	0.3	0.3	0.3	1.2	0.5	-0.7
Exports	0.5	0.5	0.2	0.3	-0.9	-0.9	-1.9
Imports	0.4	0.2	0.2	0.7	-0.5	-0.4	-1.1
Inventories	0.5	0.8	-0.8	2.0	-1.6	-0.9	-1.5

Source: National Income and Product Accounts of the United States, 1986

Chief among these five unconventional features is the consumer borrowing and spending binge. Being strongly correlated with soaring stock prices, it was the demand component in particular that dominated the boom since 1927, after fixed investment had faltered. It was in the autumn of 1927 that new Fed easing had its chief effects in supplying the stock market and consumer spending with a new, strong boost. When the stock market bubble burst in October 1929, this artificial element in GDP growth quickly evaporated. By contrast, sharp fluctuations in fixed investment are the typical and dominant characteristic of the conventional business cycle.

The preeminent technological innovation of the 1920s was the automobile. Steel, rubber and glass companies built plants to meet the voracious needs of the automakers, construction companies laid roads, oil companies dug wells and put up filling stations and developers built homes that could only be reached with the new automobile.

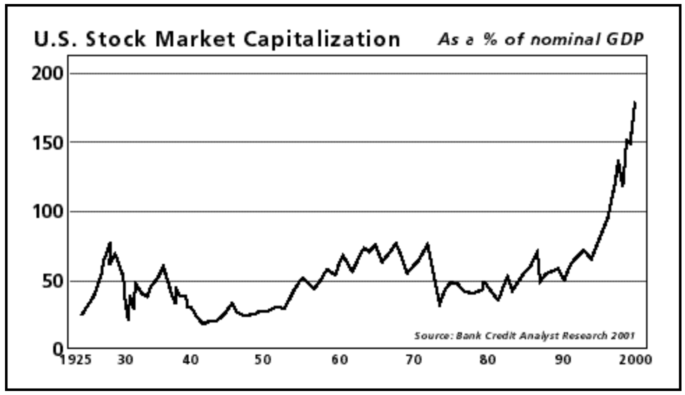
But it wasn't technology alone that created the auto boom. To turn the new technology into rapid economic growth needed the invention and the widespread acceptance of consumer installment credit enabling millions of middle- and lower-class Americans to buy a car. From the automobile, the idea spread to all sorts of consumer goods. Consumer credit was the decisive novelty in the financial sphere that made the American boom.

By 1930, installment credit financed the sales of 60-80% of all consumer durables. Such loans were anathema to bankers, who were used to making loans only to businesses and farmers, where the collateral was a productive and profit-making asset. As a result, the auto companies stepped in to offer credit. Accordingly, consumer credit appeared statistically as business credit. On top of these credits for the purchase of consumer durables was an explosion of mortgage debt as the automobile made the whole countryside accessible to private households. In short, it was the invention of consumer credit that made the boom of the 1920s so big.

How do these economic and financial imbalances between then and now compare in relative degree and magnitude? In this respect, actually, they differ like night and day. Briefly speaking: The excesses and imbalances of the 1990s are in every respect many times worse than those in the 1920s. As to the economy, this shows strikingly, in particular, in two facts: the monstrous current-account deficit of today's U.S. economy, comparing with a sizable surplus in the 1920s; and today's monstrous, negative personal saving rate. As to the financial system, it shows, of course, in today's absolutely fantastic credit and debt numbers.

Measured simply by the unprecedented collapse of personal saving, the consumer borrowing and spending excesses of the late 1990s clearly surpass those of the 1920s by far. Accordingly, the inevitable recoil will

inherently be a lot worse. To the extent that a prolonged fall in stock prices will prompt a significant normalization of the personal saving rate to at least 4-5% of disposable income – standing currently at -1% of disposable income — the U.S. economy would be condemned to years of depression. We don't see how that can be avoided.



MARKETS VERSUS BANKS

We have explored the financial events in 1929-30 that ushered in the Great Depression to expose the gross misinformation that prevails in the United States in this respect. Under the influence of the Friedman/ Schwartz book, it has become virtual dogma among American economists that central banks possess infallible power to stimulate economic growth virtually at will. The typical, popular articulation is "by printing money."

This is utter nonsense. Central banks act on the economy only indirectly through the banks and the markets. These do the actual lending to businesses and consumers. Taking no note of the asset side of banks, Friedman/Schwartz never seriously consider the possibility that banks may be held back by factors other than their reserve position. What's more, their conceptual picture completely disregards what is happening in the markets. As explained, the big credit squeeze of 1930 arose with instant, massive force from the sudden shutdown of the markets for stocks and lower-grade bonds, reflecting a drastic deterioration in economic expectations of investors. In other words, it was Wall Street and the investor that closed the credit window.

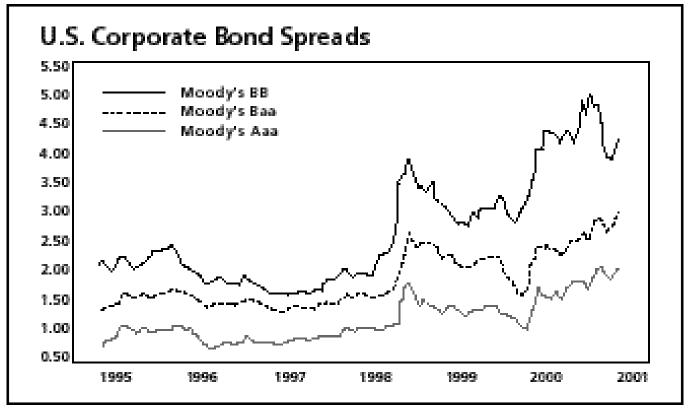
Clearly, just the same is happening presently. Nothing is easier for a central bank than to complement bank reserves and to lower its interest rate. Whether and to what extent this translates into business and consumer borrowing and spending depends on many other factors. How, though, can the high tech sector with its voracious need for credit and capital recover if the financial markets virtually seize up to its firms? There is, implicitly, a vicious circle in operation: The weakening economy depresses the markets and confidence, and the falling markets, in turn, further weaken the economy and confidence.

Once it begins to be realized that the economy is continuing to deteriorate, it will be the credit markets' and the banks' turn to cut down more sharply on their lending binge. The percentage of banks tightening lending standards for commercial and industrial loans has risen dramatically. Moreover, default rates are surging. Moody's has forecast that 11% of all rates issuers in the U.S. junk bond market will default on their bond payments in 2001, surpassing the previous peak of 10.6% in 1990.

Something to keep a particularly keen eye on are the spreads in the debt markets, which are able to abruptly shut down credit sources. As explained, their sharp rise was the cataclysmic event in late 1930 that dramatically worsened the financial climate. While historically high now, they lack a firm direction. For some sectors, telecoms for example, they have widened further, while for "defensive sectors," such as utilities and tobacco, they have tended lower.

Consumer confidence, measured by the Conference Board, has dropped sharply. Considering the former absurdly high level of expectations, however, we wonder what this actually means. More recent indexes measuring optimism are meanwhile slightly up, presumably reflecting the widespread hopes for a V-shaped recovery. From what we read and hear, we can only conclude that there still reigns raging optimism, albeit on a considerably lower level than before. For many, the worst is already over. Very few seem to see something truly serious in the offing. The parallel with 1930 in this respect is striking. It takes time and a long sequence

of bad news to break deeply embedded optimistic expectations, however unfounded they may be.



FUTURE ASPECTS

What further strikes us very oddly about the present discussion concerning U.S. economic prospects is the persistent, narrow focus on confidence. It seems to suggest that the economy's and the stock market's malaise can be blamed mostly on suddenly vanishing confidence. In turn, all it needs to revive economic growth are confidence-building rate cuts. That is unbelievably primitive, apparently revealing complete confusion and ignorance of the deeper causes that underlie the plunge of the stock market and the economy.

Recalling first the Schumpeter quote on the first page: "*No great crisis has ever come about that was not fully explainable by the objective facts of the situation.*" The U.S. economy's downturn has, actually, quite a bunch of very obvious causes. In the case of capital spending, there are plainly two major contractionary forces at work pulling it forcefully down. The one specific reason is massive excess capacity in the high tech sector, and the general reason is a savage plunge in corporate earnings across the whole economy. Clearly, the mounting woes of the high tech sector are spreading to the rest of the economy. Just as the rollout of high tech helped magnify the prior boom, the evaporation of the former euphoria is helping drag down general confidence and capital spending. Basically, the importance of information and information for production and wealth creation was ridiculously overestimated.

But plummeting capital spending will have an equally dangerous companion in contracting final demand: the inevitable unwinding of the debt-driven consumer-spending boom. Earlier we said that diving consumer demand played a decisive role in the Great Depression. It will do so in coming years. With households unable to rely on rising stock prices to pay for their retirement, they will essentially relearn to save from current income. Given the large-scale destruction of their accumulated stock market gains, which has a long way to go yet, America is probably in for sharply higher personal saving rate inherently intensifying the capital spending crisis – and the unfolding profit disaster.

PROFIT ACOPALYPSE

Now for comparison, three numbers concerning the U.S. economy in 1930: total money stock down 3%; GDP down 8.9%; profits of the manufacturing sector down 78%.

The last letter emphasized that we share the horrible profit forecast of the Levy Institute: "*Earnings will be worse than expected in the first quarter. They will be much worse than expected in the second. And rather than recovering, they will in all probability nosedive in the second half… 2001's fourth-quarter earnings decline could be the steepest in postwar history. And 2002 may be scary.*" In other words, expect another profit apocalypse.

This devastating conclusion derives from analyzing the macroeconomic flows that determine aggregate profits. Any decrease in business and consumer spending reduces business revenue and aggregate business profits in line with it. From this perspective, U.S. business profits are sure to be exposed to two big drags from business spending: the one is sharply lower inventory investment as firms scramble to cut excessive inventories. This has not even started. And the other big drag arises from sharply lower fixed investment spending, net of capital consumption.

We constantly read that businesses are boosting their profits by cutting their spending and their work force. That's the famous "fallacy of composition" of which the old economists have always been mindful: applying a micro perspective to a macro problem. Cutting expenses and investment spending appears to be the proper bottom line for a single firm, but it correspondingly reduces revenues for others. If practiced by the majority of firms, it slashes overall revenue and profits. Trying to assess the U.S. economy's prospects, think macro, not micro.

Another very big drag on business profits is bound to come from the consumer. Faced with very poor income growth and vanishing stock market wealth, he will soon come to his senses and stop his dissaving. Mere stagnation of the negative savings rate at its present level implies very weak consumer spending. Any significant rise in personal saving spells protracted, deep recession and profit apocalypse.

CONCLUSIONS:

Compared with its effectively dismal state, the prevailing perception of the U.S. economy remains wildly optimistic, with consensus forecasts still calling for a V-shaped recovery. Rarely has there been such a wide discrepancy between the "consensus" and the behavior of the financial markets.

The U.S. economy's sudden, sharp downturn accrues entirely from sliding growth in fixed investment and private consumption. Yet Mr. Greenspan and the pundit consensus stubbornly label it an inventory correction. This lie is necessary to argue that the downturn will be mild and short, implying a strong recovery in the second half of this year.

The key to fathoming the presumable severity of the developing crisis lies in appreciating the vulnerability of an economy and a financial system that have for years been exposed to the most reckless credit expansion and speculation in history.

From December through March, inflation in the United States ran at 4.4%, making for nil growth in real disposable income of private households. Essentially, higher consumer spending completely depends on higher borrowing. In January it jumped by $16 billion, after $7.2 billion in December.

The surprisingly strong dollar reflects the false optimism about the U.S. economy and the stock markets that Mr. Greenspan and the Wall Street gurus have created. Reality is sure to rive in this market, too.

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